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SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1969

No. 872

QUALITY CHEVROLET COMPANY, INC.,
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

JACK BANNER
2000 Wichita Savings Bldg.
Wichita Falls, Texas 76301
Counsel for Petitioner

Of Counsel:
HAROLD D. ROGERS
1100 Hamilton Building
Wichita Falls, Texas 76301

E. L. MENDENHALL, INC., 926 Cherry Street, Kansas City, Mo. 64106, HArrison 1-3030

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The petitioner prays that a writ of certiorari issue to review the judgment of the Court of Appeals for the Tenth Circuit.

OPINIONS BELOW

The opinion of the Court of Appeals, as yet unreported, appears at Appendix A, at page A1. The opinion of the Tax Court of the United States, 50 T.C. 458, appears at Appendix B, at page A5.

JURISDICTION

The judgment of the Court below was entered on August 26, 1969. This petition for certiorari was filed less than 90 days from the date aforesaid. A timely petition for rehearing was denied on September 27, 1969. The jurisdiction of this Court is invoked under 28 U.S.C. 1254.

QUESTION PRESENTED

Whether petitioner is entitled under section 166 (g) or section 166 (c) of the Internal Revenue Code to deduct as a reasonable addition to its reserve for bad debts for 1960, 1961 and 1962 certain amounts based upon its loss experience for payment of guaranteed and indemnified obligations to finance companies resulting from the prepayment of debt obligations by customers of petitioner.

STATUTES INVOLVED

"Sec. 166 (c) RESERVE FOR BAD DEBTS.—In lieu of any deduction under subsection (a), there shall be allowed (in the discretion of the Secretary or his delegate) a deduction for a reasonable addition to a reserve for bad debts.

(g) RESERVE FOR CERTAIN GUARANTEED DEBT OBLIGATIONS.—

(1) ALLOWANCE OF DEDUCTION.—In the case of a taxpayer who is a dealer in property, in lieu of any deduction under subsection (a), there shall be allowed (in the discretion of the Secretary or his delegate) for any taxable year ending after October 21, 1965, a deduction—

(A) for a reasonable addition to a reserve for bad debts which may arise out of his liability as a

guarantor, endorser, or indemnitor of debt obligations arising out of the sale by him of real property or tangible personal property (including related services) in the ordinary course of his trade or business; and

(B) for the amount of any reduction in the suspense account required by paragraph (4) (B) (i).

(2) DEDUCTION DISALLOWED IN OTHER CASES.—Except as provided in paragraph (1), no deduction shall be allowed to a taxpayer for any addition to a reserve for bad debts which may arise out of his liability as guarantor, endorser, or indemnitor of debt obligations.

(3) OPENING BALANCE.—The opening balance of a reserve described in paragraph (1) (A) for the first taxable year ending after October 21, 1965, for which a taxpayer maintains such reserve shall, under regulations prescribed by the Secretary or his delegate, be determined as if the taxpayer had maintained such reserve for the preceding taxable years.

(4) SUSPENSE ACCOUNT.—

(A) REQUIREMENT.—Except as provided by subparagraph (C), each taxpayer who maintains a reserve described in paragraph (1) (A) shall, for purposes of this subsection and section 81, establish and maintain a suspense account. The initial balance of such account shall be equal to the opening balance described in paragraph (3).

(B) ADJUSTMENTS.—At the close of each taxable year the suspense account shall be—

(i) reduced by the excess of the suspense account at the beginning of the year over the reserve described in paragraph (1) (A) (after making the addition for such year provided in such paragraph), or

(ii) increased (but not to an amount greater than the initial balance of the suspense account) by the excess of the reserve described in paragraph (1)(A) (after making the addition for such year provided in such paragraph) over the suspense account at the beginning of such year.

(C) LIMITATIONS.—Subparagraphs (A) and (B) shall not apply in the case of the taxpayer who maintained for his last taxable year ending before October 22, 1965, a reserve for bad debts under subsection (c) which included debt obligations described in paragraph (1)(A).

(D) SECTION 381 ACQUISITIONS.—The application of this paragraph in any acquisition to which section 381(a) applies shall be determined under regulations prescribed by the Secretary or his delegate."

STATEMENT OF THE CASE

All of the facts in this case were stipulated and are introduced to the Court in a summary fashion.

This petition for writ of certiorari by petitioner, Quality Chevrolet Company, Inc., is from a decision of the Tenth Circuit affirming a decision of the Tax Court of the United States determining additional income taxes due by the petitioner of $11,997.67, $3,158.54 and $6,926.30 for the taxable years 1960, 1961 and 1962.

Petitioner was incorporated under the laws of the State of Kansas on April 3, 1958. Since that date, the petitioner has been engaged in the business of buying, selling, repairing, and servicing automobiles as an authorized Chevrolet dealer in Wichita, Kansas. (R. 43) The petitioner used the accrual method of accounting in maintaining its books and records and reporting its income for tax purposes. Petitioner has elected and established the reserve method of accounting for bad debts. (R. 44)

The petitioner sold substantially all of its automobiles and trucks on credit. When a sale was consummated, the customer executed a promissory note for the unpaid portion of the purchase price of the vehicle plus a carrying or finance charge and other incidental costs. The promissory note was an installment note for a term agreed upon by the petitioner and the customer. (R. 44)

During all of the years that the petitioner has been a Chevrolet dealer, it has followed the practice of selling most of the promissory notes received from customers to finance companies on a discounted basis. Such notes were sold either with full recourse against the petitioner or recourse limited to the amount of the dealer reserve. (R. 44)

In a typical credit sale, the petitioner and the customer agreed upon a cash price for the vehicle and the portion to be paid immediately and the portion to be deferred. To the deferred amount, a "time-price differential" or "carrying or finance charge," together with other incidental costs, were added to arrive at a total "contract balance." The customer then executed a negotiable promissory note to the petitioner in the amount of the contract balance and agreed to pay such amount in equal monthly installments over a designated period of time, such as 3 years. The petitioner then sold the installment note to a finance company at a discount. The finance company paid petitioner the principal amount of the note and credited a portion of the finance charge to a dealer reserve account in the name of the petitioner. A typical sale may be illustrated by the following example:

I. Sale of vehicle:		
1. Cash price of vehicle		$4,000.00
2. Unpaid portion	$3,000.00	
3. Finance charge and other incidental costs	720.00	
4. Contract balance or amount of installment note	$3,720.00	
II. Sale of note:		
1. Financial institution discount	$ 360.00	
2. Credited to dealer reserve	360.00	
3. Paid to the petitioner	3,000.00	
Total	$3,720.00	(R. 44, 45)

The $360.00 in the example credited to the dealer reserve account represented the petitioner's participation in the finance charge based upon its full collection by the finance company. The petitioner reported as accrued income on its returns all amounts credited to its dealer reserve accounts by the several finance companies. Such amounts totaled $78,749.69 for 1960, $87,334.90 for 1961, and $132,697.27 for 1962. As of December 31 of each year, the petitioner carried outstanding accounts receivable due from the several finance companies and relating solely to dealer reserve accounts in the amounts of $47,016.89 for 1960, $52,145.71 for 1961, and $59,094.10 for 1962. (R. 45, 46)

During the years involved in this case, section 16-509 of the General Statutes of Kansas required a reduction in the finance charge in the event a customer prepaid the balance due on his note before its maturity date. In accord

with the agreements between the petitioner and the finance companies, when a prepayment occurred, the finance company charged the petitioner's dealer reserve account with a proportionate part of the reduction in the finance charge, or the petitioner paid cash to the finance company in the event that the dealer reserve account was insufficient to cover all of such charge. In the example given above, if the customer, after making a number of payments on the $3,720.00 note, prepaid the remaining balance of the note and was thereby entitled to a reduction of the finance charge in the amount of $160.00 under Kansas law, the finance company would charge the petitioner's dealer reserve account for $80.00 or require the petitioner to pay that amount in cash. In the event of prepayment, the petitioner had no liability to the finance company in excess of the amount originally credited to its dealer reserve account on each specific contract. (R. 46, 47)

In the event of prepayment, petitioner had no liability to the financial institution for the time price differential in excess of the amount credited to its dealer reserve account on each specific contract, but petitioner was obligated to pay a proportionate part of the previously accrued finance participation income in cash or as a charge to its dealer reserve account not to exceed the credit balance in the dealer reserve account on each specific contract. (R. 51)

In the event the customer defaulted in his payments on an installment note sold to the financial institution with limited recourse, the vehicle would be repossessed by the financial institution. The petitioner's dealer reserve account on the books of the financial institution was charged with the loss sustained by the financial institution on the note, not to exceed the credit in the dealer's reserve account for that particular contract or petitioner paid in cash such loss in the event the dealer reserve account was insufficient. (R. 52)

The amounts that were charged to the petitioner's dealer reserve account or paid in cash because of prepayments by customers totaled $15,396.31 for 1960, $12,730.78 for 1961, and $16,546.37 for 1962. (R. 48)

The petitioner elected on its first tax return to deduct bad debt losses on the reserve method of accounting. In computing its bad debt experience with respect to notes sold to finance companies, the petitioner considered its loss experience from repossessions and also from prepayments by customers. (R. 49, 50)

REASONS FOR GRANTING THE WRIT

1. The decision below is in direct conflict with this Court's Hansen decision.

In *Commissioner* v. *Hansen,* (1959) 360 U.S. 446, this Court held that all payments out of a "dealer reserve account" were made because of the contractual liability of the dealer resulting from the sale of debt obligations. Thus, this Court held that the dealer had a "fixed right" to receive the amounts placed in the dealer reserve account and such amounts represented taxable income.

The lower court stated in its opinion that the *Hansen* case was applicable to the instant facts. If so then *Hansen* should be controlling for all purposes. The *Hansen* case held that income must be accrued from the dealer reserve account even though the liability of the dealer is a contingent liability. Thus, the lower court's opinion is in direct conflict with the rule of *Hansen* as follows:

(1) By holding that petitioner's losses from prepayment of a note by a customer "do not arise out of its status as guarantor or indemnitor of a debt obligation."

(2) By holding that petitioner's losses resulting from prepayment of the notes were "unrelated to an existing debt obligation."

In clearly holding that all payments out of a "dealer reserve account" were made because of the contractual liability of the dealer, this Court said in *Hansen* at 360 U.S. page 465:

> "It is true that the amounts retained by any one of the finance companies, and entered on its books as a liability to a particular dealer, are subject to such liabilities as the dealer may have contractually assumed to the finance company, but only the obligations of the dealer to the finance company arising from those liabilities may be offset against a like amount in the dealer's reserve account. Hence, those liabilities and obligations provide the only conditions that can affect full cash payment to the dealer of his reserve account. No amount may be charged by the finance company against the dealer's reserve account which he has not thus authorized."

The above quoted statement is directly applicable to the instant case. Petitioner agreed with the finance companies to be liable for any loss realized by the finance companies in the collection of the debt obligations sold. That agreement is clearly set forth in the stipulated facts. (R. 46, 47) No amount could be charged by the finance company against petitioner except for charges which petitioner had authorized. Thus, the facts in the instant case are identical to the facts in *Hansen* ie. the liability as guarantor resulted from the sale of debt obligations. Therefore, the decision by the Tenth Circuit is in direct conflict with this Court's decision in *Hansen* since petitioner had no other liability other than its liability as guarantor of debt obligations sold to the various finance companies.

This Court stated at 360 U.S. page 465 in *Hansen* that only one or the other of two things can happen to a dealer's reserve account:

> "It follows that only one or the other of two things can happen to the dealer's reserve account: (1) the finance company is bound to pay the full amount to the dealer in cash, or (2) if the dealer has incurred obligations to the finance company under his guaranty, endorsement, or contract of sale, of the installment paper, the finance company may apply so much of the reserve as is necessary to discharge those obligations, and is bound to pay the remainder to the dealer in cash."

Petitioner agreed in its contracts with the finance companies to receive its reserve in offset payment of its obligations to each finance company and the balance in cash. The withheld amounts credited to the reserve were entered on the books of the finance companies *as liabilities to the petitioner subject to any charges as agreed upon by the guarantee, endorsement or contract.*

It is thus made clear that petitioner's losses did arise out of its status as guarantor, the same as the dealer's losses in *Hansen*, and the holding of the Tenth Circuit is directly in conflict with *Hansen.*

Further, this Court in *Hansen* considered the liability for prepayments as *directly related* to the debt obligations sold. In fact, this Court held that no liability existed other than the liability stated in the guaranty agreement. The following statement relating to prepayments is found at 360 U.S. 454 footnote 5:

> "If because of prepayment of a note by a maker, C.I.T. refunded any part of a 'service charge', the taxpayer agreed to pay to C.I.T. the same percentages, if any, of the refund as had originally been credited to his reserve account."

The facts in the instant case are identical to *Hansen* as far as the guaranty agreement relating to prepayments is concerned. The sole liability of petitioner resulted from

its agreement to guarantee the debt obligations sold. The liability of petitioner under its agreements with the finance companies was the same whether the notes were defaulted or prepaid. No other liability existed. Petitioner's losses were directly *related* to the debt obligations sold to the finance companies. No other agreement existed between the finance companies and petitioner except the guaranty agreement relating to the sale of debt obligations. The same facts existed in *Hansen* i.e. no other liability existed other than the taxpayers' agreement to guarantee losses realized whether the notes were defaulted or prepaid. Thus, the rule laid down in *Hansen* authorizes petitioner under section 166(c) to deduct as a reasonable addition to its reserve amounts based upon its loss experience for payment of guaranteed obligations resulting from prepayments by its customers.

Under section 166(g) a reserve is only permitted where there is a guarantee, endorsement, or indemnification of a liability arising from the sale of personal or real property by a dealer who discounts notes received upon the sale of such personal or real property. The contractual arrangements of petitioner with the finance company to repay the finance company for any losses realized from prepayments by customers was a very definite contingent liability and covered specifically by section 166(g). It is the debt that created the prepayment and it was petitioner's contractual obligation to reimburse the finance company because of the prepayment of that debt. The legal requirement for the prepayment allowance as provided by Kansas law did not in any manner remove the contingent liability of petitioner to reimburse or repay the finance company when the discounted notes were prepaid. This contingent liability existed on the part of the petitioner under its various contracts whether the discounted notes were defaulted or prepaid. The agreement with the fi-

nance company is controlling where there is a contingent liability on the part of the dealer. If such contingent liability exists in relationship to discounted paper, section 166(g) specifically provides that a reserve for bad debts may be claimed as a deduction for such contingency.

Petitioner's position herein is also fortified by the House Committee Report on P.L. 89-722 which makes it very clear that section 166(g) was intended to include all contingent liabilities for which the reserve is maintained. That report states as follows:

> "The determination of the year end balance of the reserve for guaranteed debt obligations is made after adding any addition needed to provide a reasonable reserve for the outstanding *contingent liabilities* for which the reserve is maintained." (Emphasis supplied)

Further, the House Report states as follows:

> "The deduction is for a reasonable addition to a reserve for bad debts which may arise out of the dealer's *liability as a guarantor, endorser, or indemnitor of debt obligations.* Generally, debt obligations which are sold without recourse do not result in any liability of the dealer as a guarantor, endorser or indemnitor. However, there are certain without-recourse transactions in which the dealer may have a liability as a guarantor or indemnitor to the financial institution. For example, the holder or transferee of the debt obligation holds money or other property of the dealer *which it may apply without seeking permission of the dealer* against any uncollectible debt obligations transferred by the dealer, or if the dealer is under a legal duty to reacquire the real or tangible personal property from the holder or transferee who repossessed such property in satisfaction of the debt obligation, then the *dealer's liability, if any, is considered to arise out of his liability as a guarantor, endorser, or indemnitor of such debt obligation.*" (Emphasis supplied)

The above example cited by the House Committee is exactly the situation found here. Petitioner sold the notes received from the sale of automobiles to the various finance companies with recourse. When a prepayment of a note was made by a customer, the particular finance company would either reduce petitioner's dealer reserve account or if such account was insufficient to cover such loss, then petitioner would pay such amount in cash. Thus, the facts here clearly show that petitioner had a contingent liability since the finance companies had the right to apply petitioner's dealer reserve accounts toward prepayment losses without seeking permission of petitioner.

In summary petitioner submits that the decision of the Tenth Circuit is in direct conflict with this Court's decision in *Hansen* as follows:

(1) *Hansen* held that the amounts charged to a dealer reserve account arise out of the dealer's status as guarantor of debt obligations, *whereas*, the Tenth Circuit held that the amounts charged to the dealer reserve account by the various finance companies did not result from petitioner's status as guarantor or indemnitor of debt obligations; and

(2) *Hansen* held that contracts to reimburse the finance company for the notes sold are *related* to the notes discounted as the contracts are a contingent obligation to pay any deficit of the notes discounted, *whereas*, the Tenth Circuit held that petitioner's losses under its contract with the finance companies were *unrelated* to existing debt obligations.

2. The decision below is in conflict with decisions of other courts of appeal involving the identical issue.

The following cases have held that a taxpayer is entitled to include in his computation of bad debt experience all losses arising out of his contingent liability from the

failure of the finance companies to collect the full amount of discounted notes sold by the taxpayer. *Wilkins Pontiac* v. *Commissioner*, (C.A. 9th 1961) 298 F.2d 893; *Bolling* v. *Commissioner*, (C.A. 8th 1966) 357 F.2d 3; *Foster Frosty Foods* v. *Commissioner*, (C.A. 10th 1964) 332 F.2d 230.

The facts in the instant case are identical to the facts in each of the above mentioned cases. In each case including the instant case, the taxpayer is contingently liable for losses realized upon the collection of discounted notes by the various finance companies. It makes no difference whether the loss is due to default or prepayment. In each case there is an agreement of guaranty. And in the three above mentioned cases each court of appeals held that the taxpayer was entitled to an addition to his bad debt reserve under section 166(c) even though his liability was solely a contingent liability.

Petitioner submits that the decision of the Tenth Circuit is in conflict with the decisions in the *Wilkins Pontiac*, *Bolling* and *Foster Frosty Foods* cases and, therefore, this petition should be granted.

CONCLUSION

For the foregoing reasons, this Petition for a Writ of Certiorari should be granted.

Respectfully submitted,

JACK BANNER
2000 Wichita Savings Bldg.
Wichita Falls, Texas 76301
Counsel for Petitioner

Of Counsel:
HAROLD D. ROGERS
1100 Hamilton Building
Wichita Falls, Texas 76301

APPENDIX

APPENDIX A

United States Court of Appeals

TENTH CIRCUIT

July Term, 1969

QUALITY CHEVROLET COMPANY, INC.,
Petitioner,
v.
COMMISSIONER OF INTERNAL REVENUE,
Respondent.
} No. 35-69

Petition for Review of a Decision of the Tax Court of the United States

(Filed August 26, 1969)

Harold D. Rogers, Wichita Falls, Texas (Eggers, Sherrill, Pace & Rogers, Of Counsel, on the brief) for Petitioner.

Jonathan S. Cohen (Johnnie M. Walters, Assistant Attorney General, Lee A. Jackson, Gilbert E. Andrews and Louis M. Kauder, Department of Justice, Washington, D.C., on the brief) for Respondent.

Before LEWIS, BREITENSTEIN and HICKEY, Circuit Judges.

LEWIS, Circuit Judge.

Pursuant to 26 U.S.C. § 7482 petitioner-taxpayer seeks review of a decision of the Tax Court of the United States holding petitioner, Quality Chevrolet Company, Inc., liable for income tax deficiencies in the amount of $11,997.67 in the year 1960, $3,158.54 in the year 1961 and $6,926.30 in the year 1962. The deficiencies were prem-

ised upon the court's determination that taxpayer improperly added to its reserve for bad debts anticipated losses resulting from the prepayment of debt obligations by its customers. The sole issue presented for review is whether taxpayer is correct in its assertion that it is entitled under 26 U.S.C. § 166(g) or in the alternative 26 U.S.C. § 166(c) to deduct a reasonable addition to its reserve for bad debts for 1960, 1961 and 1962 for the anticipated losses. The facts are undisputed and may be summarized.

Petitioner-taxpayer is engaged in the business of selling, repairing and servicing automobiles and trucks as an authorized Chevrolet dealer in Wichita, Kansas. Most of the sales of automobiles and trucks by taxpayer were credit transactions with the customer making a small down payment and executing a promissory note (instalment) for the balance which then included a finance charge and other incidental costs. Taxpayer's usual practice was to sell these notes at a discount with full or partial recourse to finance companies who in turn would pay taxpayer the principal amount of the note and credit a portion of the finance charge to a dealer reserve account in the name of taxpayer. The dealer reserve account represented taxpayer's participation in the finance charge based on full collection by the finance company. The portion of the finance charge not credited to taxpayer's reserve account was the finance company's profit on the transaction. Taxpayer, who was on the accrual method of accounting, correctly reported as accrued income all amounts credited to dealer reserve accounts. Commissioner v. Hansen, 360 U.S. 446. Such amounts totaled $78,749.69 for 1960, $87,334.90 for 1961 and $132,697.27 for 1962.

The reserve account was in part maintained because of the then-existing Kansas law, Kan. Stat. Ann. § 16-509 (1964),[1] which required a creditor to reduce the finance charge when the debtor-customer prepaid the balance due on his note before its maturity date. In accordance with the agreement between taxpayer and the financial institutions, when a customer prepaid his note the finance company would reduce taxpayer's reserve account with a proportionate part of the reduction in the finance charge. If the reserve account was not sufficient to cover the charges, taxpayer would pay the difference in cash. The amounts that were charged to taxpayer's dealer reserve account or paid in cash because of prepayments by customers totaled $15,396.31 for 1960, $12,730.78 for 1961 and $16,546.37 for 1962.

Taxpayer elected the reserve method of accounting for bad debts and contends herein that it is entitled under § 166(c) or (g) to deduct the contested amounts as a reasonable addition to its reserve based upon its loss experience from the prepayments and the resulting reduction of its reserve accounts. The government concedes that when prepayment occurs and the taxpayer's reserve account is reduced a deduction under 26 U.S.C. § 162(a) or § 165(a) is proper, but argues that § 166 does not authorize anticipation of the loss from prepayment. We agree.

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1. During the years involved § 16-509 provided:

Notwithstanding the provisions of any retail installment contract to the contrary, any buyer may prepay in full, whether by payment in cash, extension, renewal, or otherwise, at any time before maturity the debt of any retail installment contract and in so paying such debt shall receive a refund credit thereon for such anticipation of payments. The amount of such refund shall represent at least as great a proportion of the finance charge as the sum on the monthly time balances beginning one (1) month after prepayment is made, bears to the sum of all the monthly time balances under the schedule of payment in the contract. Where the amount of credit is less than one dollar ($1) no refund need be made.

In lieu of 26 U.S.C. § 166(a),[2] 26 U.S.C. § 166(c)[3] and (g) allow a current deduction in the form of a reasonable addition to bad debt reserve for bad debts attributable to current income but arising later; however, neither the terms of § 166(c) nor (g), or for that matter § 166(a), call for or allow a deduction for losses which do not originate from an existing debt obligation. *See* Wilkins Pontiac v. Commissioner, 9 Cir., 298 F.2d 893.[4]

Section 166(g), which in its pertinent part provides for "a reasonable addition to a reserve for bad debts which may arise out of his [taxpayer's] liability as a guarantor, endorser or indemnitor of *debt obligations* arising out of the sale by him of real property or tangible personal property (including related services) in the ordinary course of his trade or business. . . ." (emphasis added), was designed to settle an issue that had been considered by several courts of appeal, including this circuit. Foster Frosty Foods, Inc. v. Commissioner, 332 F.2d 230; S. Rep. No. 1710, 89 Cong. 2d Sess., 3 U.S. Code Cong. & Ad. News 3764, 3765 (1966). Section 166 does not, nor do the cases which led to its enactment, extend the coverage of that provision to losses unrelated to an existing debt obligation. *See* Bolling v. Commissioner, 8 Cir., 357 F.2d 3; Foster Frosty Foods, *supra;* Wilkins Pontiac, *supra.*

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2. 26 U.S.C. § 166(a) provides that "[t]here shall be allowed as a deduction any debt which becomes worthless within the taxable year."

3. 26 U.S.C. § 166(c) provides that "[i]n lieu of any deduction under subsection (a), there shall be allowed (in the discretion of the Secretary or his delegate) a deduction for a reasonable addition to a reserve for bad debts."

4. In Wilkins Pontiac, *supra* at 895, the court in considering the applicability of 26 U.S.C. § 166(c) to indirect debts stated that § 166(c) apparently must relate *"to an existing debt* as to which taxpayer in the ordinary course of business may ultimately *sustain a bad debt loss."* (emphasis added).

The anticipated losses from which taxpayer seeks an addition to its bad debt reserve do not arise out of its status as guarantor or indemnitor of a debt obligation,[5] § 166(g), or its status as a creditor of the financial institutions, § 166(c); rather they arise out of the premature extinguishment of debts by its customers—taxpayer being required by agreement with the financial institutions to share in the mandatory reduction of the service charge. Kan. Stat. Ann. § 16-509 (1964). The anticipated loss, as was argued by the Commissioner, is clearly a payment in the nature of a refund rather than one arising from bad debts and accordingly beyond the scope of § 166(c) or (g). *Cf.* Brown v. Helvering, 291 U.S. 193. The effect of the prepayment is not to create a bad debt but to reduce the amount of the debt to zero.

The Tax Court correctly concluded that "when the petitioner suffers a loss because of prepayment of a note by a customer, the loss is not a bad debt loss within the meaning of section 166."

AFFIRMED.

APPENDIX B

50 T. C. No. 44

TAX COURT OF THE UNITED STATES
QUALITY CHEVROLET COMPANY, INC., Petitioner v. COMMISSIONER OF INTERNAL REVENUE, Respondent
Docket No. 5887-64. Filed June 10, 1968.

The petitioner sold automobiles on credit and discounted the promissory notes with several financial in-

5. The Commissioner concedes, as indeed he must, that repossession losses which occurred by reason of default can be considered by taxpayer in its computation of additions to bad debt reserves.

stitutions. Such institutions established dealer reserve accounts to which were credited portions of the finance charges on the notes. Such portions were based upon anticipated full payment of the finance charges, and the petitioner reported as accrued income all such credits to its dealer reserve accounts. In the event a customer prepaid his note, the full finance charge would not be realized, and the financial institution would accordingly charge the petitioner's dealer reserve account with its portion of the reduction in the finance charge.

Held: That petitioner's losses due to the prepayment of notes were not losses due to the worthlessness of debts, and a reserve for such anticipated losses is not recognized for tax purposes.

Harold D. Rogers and *Paul W. Eggers*, for the petitioner.

James F. Hart, for the respondent.

SIMPSON, *Judge*: The respondent determined deficiences in income tax of the petitioner of $11,503.21 for its taxable year 1960, $1,708.28 for its taxable year 1961, and $10,319.77 for its taxable year 1962. The only issue remaining for decision is whether the petitioner may deduct additions to its reserve for bad debts to provide for anticipated losses due to the prepayment of promissory notes by its customers.

FINDINGS OF FACT

All of the facts were stipulated, and those facts are so found.

The petitioner, Quality Chevrolet Company, Inc., was incorporated under the laws of the State of Kansas on April 3, 1958. Since that date, the petitioner has been engaged in the business of buying, selling, repairing, and

servicing automobiles as an authorized Chevrolet dealer in Wichita, Kansas, its principal place of business at the time the petition was filed in this case. The petitioner used the accrual method of accounting in maintaining its books and records and reporting its income for tax purposes. The petitioner has elected and established the reserve method of accounting for bad debts.

The petitioner sold substantially all of its automobiles and trucks on credit. When a sale was consummated, the customer executed a promissory note for the unpaid portion of the purchase price of the vehicle plus a carrying or finance charge and other incidental costs. The promissory note was an installment note for a term agreed upon by the petitioner and the customer.

During all of the years that the petitioner has been a Chevrolet dealer, it has followed the practice of selling most of the promissory notes received from customers to several financial institutions on a discounted basis. Such notes were sold either with full recourse against the petitioner or recourse limited to the amount of the dealer reserve.

In a typical credit sale, the petitioner and the customer agreed upon a cash price for the vehicle and the portion to be paid immediately and the portion to be deferred. To the deferred amount, a "time-price differential" or "carrying or finance charge," together with other incidental costs, were added to arrive at a total "contract balance." The customer then executed a negotiable promissory note to the petitioner in the amount of the contract balance and agreed to pay such amount in equal monthly installments over a designated period of time, such as 3 years. The petitioner then sold the installment note to a financial institution at a discount. The financial institu-

tion paid the petitioner the principal amount of the note and credited a portion of the finance charge to a dealer reserve account in the name of the petitioner. A typical sale may be illustrated by the following example:

I. Sale of vehicle:		
1. Cash price of vehicle		$4,000.00
2. Unpaid portion	$3,000.00	
3. Finance charge and other incidental costs	720.00	
4. Contract balance or amount of installment note	$3,720.00	
II. Sale of note:		
1. Financial institution discount	$ 320.00	
2. Credited to dealer reserve	400.00	
3. Paid to the petitioner	3,000.00	
Total	$3,720.00	

The $400.00 in the example credited to the dealer reserve account represented the petitioner's participation in the finance charge based upon its full collection by the financial institution. The petitioner reported as accrued income on its returns all amounts credited to its dealer reserve accounts by the several financial institutions. Such amounts totaled $78,749.69 for 1960, $87,334.90 for 1961, and $132,697.27 for 1962. As of December 31 of each year, the petitioner carried outstanding accounts receivable due from the several financial institutions and relating solely to dealer reserve accounts in the amounts of $47,016.89 for 1960, $52,145.71 for 1961, and $59,094.10 for 1962.

During the years involved in this case, section 16-509 of the General Statutes of Kansas required a reduction in the finance charge in the event a customer prepaid the balance due on his note before its maturity date. In accord with the agreements between the petitioner and the financial institutions, when a prepayment occurred, the financial institution charged the petitioner's dealer reserve account with a proportionate part of the reduction in the finance charge, or the petitioner paid cash to the financial institution in the event that the dealer reserve account was insufficient to cover all of such charge. In the example given above, if the customer, after making a number of payments on the $3,720.00 note, prepaid the remaining balance of the note and was thereby entitled to a reduction of the finance charge in the amount of $160.00 under Kansas law, the financial institution would charge the petitioner's dealer reserve account for $88.89 or require the petitioner to pay that amount in cash. In the event of prepayment, the petitioner had no liability to the financial institution in excess of the amount originally credited to its dealer reserve account on each specific contract.

The amounts that were charged to the petitioner's dealer reserve account or paid in cash because of prepayments by customers totaled $15,396.31 for 1960, $12,730.78 for 1961, and $16,546.37 for 1962.

The petitioner elected on its first tax return to deduct bad debt losses on the reserve method of accounting. In computing its bad debt experience with respect to notes sold to financial institutions, the petitioner considered its loss experience from repossessions and also from prepayments by customers.

As of the date of trial, the statute of limitations was still open for assessment as to the petitioner's taxable years 1963, 1964, 1965, and 1966.

OPINION

Our question is whether the petitioner may anticipate losses due to the prepayment of promissory notes by its customers by means of additions to its reserve for bad debts. Initially, other issues were raised in this case, but the parties now agree that the amounts credited to the petitioner's reserve accounts are includable in its income and that the petitioner may deduct additions to a reserve with respect to its repossession losses. Since the petitioner does include in its income its share of the anticipated finance charge, it is apparent that whenever the petitioner is unable to collect all of such previously accrued income, a real, economic loss is suffered, regardless of the reason for the inability to collect. The respondent concedes that such a loss is deductible at the time it occurs. However, the respondent's position is that a loss of anticipated income because of prepayment of a note is not a loss due to a "bad" debt, and therefore, such a loss may not be taken into consideration in computing a reserve for bad debts under section 166 of the Internal Revenue Code of 1954.[1] The petitioner argues that a loss because of prepayment of a note is a loss arising from a debt—a legal obligation to pay the total finance charges—and that such a loss is due to the debt being partially uncollectible under State law.

Our basic issue, thus, is not the deductibility of the loss of anticipated income due to the prepayment of the notes; rather, it is the narrower question of whether such

1. All statutory references are to the Internal Revenue Code of 1954 unless otherwise indicated.

losses may be anticipated for tax purposes by the establishment of a reserve. Accordingly, we have again the question of whether a reserve is to be recognized for tax purposes. To view that question in proper perspective, let us review the history of the issue.

In *Brown* v. *Helvering,* 291 U.S. 193 (1934), the taxpayer, a general agent for certain fire insurance companies, attempted to deduct additions made to a reserve that had been established to provide for premium losses due to the cancellation of insurance policies. The Court stated that such additions were obviously not expenses paid during the taxable year; they were only bookkeeping charges. A liability may be treated as an expense incurred only if it has "accrued" during the taxable year, even though payment is not presently due. "But no liability accrues during the taxable year on account of cancellations which it is expected may occur in future years, since the events necessary to create the liability do not occur during the taxable year. Except as otherwise specifically provided by statute, a liability does not accrue as long as it remains contingent." (291 U.S. at 200).

Brown v. *Helvering, supra,* has been thought to establish the general rule that deductions cannot be taken for additions to reserves for contingent liabilities in the absence of specific statutory authority. However, there have been cases in which deductions were allowed for estimates for future expenses or losses when the liability seemed assured. E.g. *Schuessler* v. *Commissioner,* 230 F.2d 722 (C.A. 5, 1956), revg. 24 T.C. 247 (1955); *Harrold* v. *Commissioner,* 192 F.2d 1002 (C.A. 4, 1951), revg. 16 T.C. 134 (1951).

With the passage of the Internal Revenue Code of 1954, Congress provided in section 462 for the use of re-

serves for estimated expenses; at the same time, Congress, in section 452, provided for the deferral of prepaid income. The two sections were designed to eliminate the variances between tax accounting and business accounting by more nearly attributing income to the year in which it was earned and allowing deductions attributable to the activities of earning that year's income. However, because of transitional problems, sections 452 and 462 were repealed retroactively in the Act of June 15, 1955, ch. 143, 69 Stat. 134.

Since the repeal of sections 452 and 462, the courts have considered a number of cases in which taxpayers sought to defer income or anticipate expenses without specific statutory authorization to do so. On three occasions, the issue has been presented to the Supreme Court, and it has consistently refused to approve of the use of such accounting methods without statutory authorization. *Schlude* v. *Commissioner*, 372 U.S. 128 (1963); *American Automobile Assn.* v. *United States*, 367 U.S. 687 (1961); *Automobile Club of Michigan* v. *Commissioner*, 353 U.S. 180 (1957). In the *American Automobile Assn.* case, the Court said:

> To recapitulate, it appears that Congress has long been aware of the problem this case presents. In 1954 it enacted § 452 and § 462, but quickly repealed them. Since that time Congress has authorized the desired accounting only in the instance of prepaid subscription income, which, as was pointed out in *Michigan*, is ratably earned by performance on "publication dates after the tax year." * * * It has refused to enlarge § 455 to include prepaid membership dues. At the very least, this background indicates congressional recognition of the complications inherent in the problem and its seriousness to the general revenue. We must leave to the Congress the fashioning

> of a rule which, in any event, must have wide ramifications. The Committees of the Congress have standing committees expertly grounded in tax problems, with jurisdiction covering the whole field of taxation and facilities for studying considerations of policy as between the various taxpayers and the necessities of the general revenues. The validity of the long-established policy of the Court in deferring, where possible, to congressional procedures in the tax field is clearly indicated in this case. * * * [367 U. S. at 697]

The Tax Court has also considered a variety of situations in which taxpayers adopted one of these accounting methods, but in the light of the legislative history and the holdings of the Supreme Court, we have uniformly refused to approve of the deferral of income or the anticipation of expenses. E.g. *Artnell Co.*, 48 T.C. 411 (1967), on appeal (C.A. 7, Oct. 23, 1967); *Hagen Advertising Displays, Inc.*, 47 T.C. 139 (1966), on appeal (C.A. 6, Apr. 3, 1967); *Simplified Tax Records, Inc.*, 41 T.C. 75 (1963).

In the meantime, Congress has decided to allow the use of these methods of accounting under restricted circumstances. See section 166(g), *infra;* section 455, prepaid subscription income; section 456, prepaid dues income of certain membership organizations. Congress has acted on a case-by-case basis, and after considering the needs of the specific situation, it has allowed the deferral of income or the anticipation of expenses with appropriate restrictions and conditions.

From this history, we infer the proposition that the decision as to whether a taxpayer is to be permitted to defer income or anticipate expenses in any specific situation is to be left to Congress. The courts will not authorize the use of either of such accounting methods with-

out specific statutory authorization.[2] When Congress does act, we will of course attempt to carry out the purpose of the legislation by approving of the reserves contemplated by Congress, but we should not extend the application of the legislation by analogy to other situations not contemplated by Congress.[3]

The petitioner in this case attempts to bring its cause within one of the new statutory authorizations, section 166(g), enacted in 1966 (Act of November 2, 1966, Pub. L. 89-722, 80 Stat. 1151). This provision was enacted as a result of the controversy over whether dealers in personal property were entitled to establish reserves with respect to their liability as guarantors on the obligations which they accepted in payment for the property they sold and which they discounted with a financial institution. Section 166(g)(1) provides:

SEC. 166. BAD DEBTS.

* * *

(g) Reserve for Certain Guaranteed Debt Obligations.—

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2. This attitude of allowing reserves only when specifically authorized by legislation is not only consistent with the decision of this Court in *Budget Credits, Inc.*, 50 T.C. .(Apr. 15, 1968), but is also consistent with the views of the minority in that case. In that case, the question was whether a business was to be denied the tax benefit of sec. 166(g) because it formed a separate corporation to handle its credit obligations, and the minority thought that the application of sec. 166(g) should not be denied merely because of the technicality of separate incorporation. On the other hand, in the case before us, the question is whether a reserve is to be allowed for prepayment losses—an anticipated expense not specifically mentioned in the statute.

3. This view applies to taxpayers who determine their tax under the general provisions of the tax law. However, such approach does not necessarily apply to taxpayers, such as insurance companies, for which the law recognizes a number of reserves in view of the peculiar nature of their business. See sec. 801 and following.

> (1) Allowance of deduction.—In the case of a taxpayer who is a dealer in property, in lieu of any deduction under subsection (a), there shall be allowed (in the discretion of the Secretary or his delegate) for any taxable year ending after October 21, 1965, a deduction—
>
> > (A) for a reasonable addition to a reserve for bad debts which may arise out of his liability as a guarantor, endorser, or indemnitor of debt obligations arising out of the sale by him of real property or tangible personal property (including related services) in the ordinary course of his trade or business; and
> >
> > (B) for the amount of any reduction in the suspense account required by paragraph (4)(B)(i).

This provision is also made applicable to earlier taxable years, including the years in controversy in this case, under circumstances which the petitioner satisfies. Sec. 2, Act of November 2, 1966.

The petitioner argues that it is a dealer in personal property, it has elected to use the reserve method for bad debts, its loss resulting from the prepayment of the notes arises in connection with an obligation which it received in payment for personal property sold in its business, and its loss results from its liability to indemnify the financial institution. It supports its argument by referring to certain statements in the committee report accompanying the enactment of section 166(g) and claiming that such statements indicate that the reserve authorized by section 166(g) is to cover all contingent liabilities arising in connection with the obligation.

In our opinion, however, the petitioner's argument rests upon too loose a construction of the statute. The deduction allowed by section 166(g) is in lieu of the de-

duction allowed by section 166(a) for debts that become worthless. Also, the reserve authorized by section 166(g) is for a bad debt, and it is clear throughout the statutory provisions and the legislative history that the provision applies only to a reserve for the liability of a guarantor, endorser, or indemnitor which results from a debt becoming bad or worthless. The statements in the committee report referred to by the petitioner are taken out of context; when considered in context, it is clear that such statements relate to the liability resulting from a debt becoming worthless. Properly construed, the only reserve authorized by section 166(g) is for debts that become worthless.

The losses sustained by the petitioner as a result of the prepayment of the notes are not losses resulting from the worthlessness of a debt. A debt becomes worthless within the meaning of section 166 when it is uncollectible because the debtor is unwilling or unable to pay. However, the prepayment losses are not due to the debtor's unwillingness or inability to pay but occur because he chooses to satisfy the debts in advance of their maturity.

Our case is one in which the purchaser of the automobile, under Kansas law, does not have an unconditional obligation to pay the financial institution the face amount of his note. In the event of prepayment, his debt is fully satisfied by paying a lesser amount. The financial institution then has no legal redress against the purchaser. Likewise, the financial institution does not have an unconditional obligation to the petitioner to pay over the full amount of the dealer reserve account. The financial institution's obligation to the petitioner is conditioned upon full payment of the note by the purchaser. Thus, the full amount of the note cannot be collected, not because of a refusal or inability to pay on the part of the

debtor, but because under Kansas law, the debtor does not owe the full amount.

The petitioner also relies upon an unpublished opinion of this Court in *Dixie Fowler*, 26 T.C.M. 175, 1967 P.-H. Tax Ct. Mem. par. 67,036 (1967). That case involved a dealer in property who made sales on credit, discounted the obligations, and assumed the liability of a guarantor. He claimed a reserve for both his repossession losses and his prepayment losses. This Court held that under the effective date provisions of the Act of November 2, 1966, he was not entitled to deduct an addition to a reserve for bad debts since he had not established any such reserve timely. Accordingly, the Court did not hold that prepayment losses could be taken into consideration in computing a reserve for bad debts.

We conclude that when the petitioner suffers a loss because of prepayment of a note by a customer, the loss is not a bad debt loss within the meaning of section 166. Consequently, the petitioner is not entitled to the special treatment provided by Congress in that section, but must deduct its loss under the general rule of *Brown* v. *Helvering, supra*—in the year in which it occurs. Because of our conclusion, we do not have to decide whether the petitioner's situation falls more clearly under section 166 (c), on the theory that such losses were suffered on a direct debt from the financial institution to the petitioner, or under section 166(g), on the theory that the petitioner was a guarantor of a debt.

In order to reflect the agreement of the parties concerning other adjustments in the notice of deficiency,

Decision will be entered under Rule 50.

SUPREME COURT, U. S.

No. 453

CLERK

In the Supreme Court of the United States

OCTOBER TERM, 1968

QUALITY CHEVROLET COMPANY, INC., PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

ERWIN N. GRISWOLD,
Solicitor General,

JOHNNIE M. WALTERS,
Assistant Attorney General,

MEYER ROTHWACKS,
JANET R. SPRAGENS,
Attorneys,
Department of Justice,
Washington, D.C. 20530.

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